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No. _____

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1989

JEROME MIRZA & ASSOCIATES, LTD.,
an Illinois corporation,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTION PRESENTED

Whether an enrolled actuary's selection of actuarial assumptions and method for a defined benefit pension plan should be deferentially reviewed as a fiduciary decision under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.* ("ERISA").

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OPINIONS BELOW

The opinion of the United States District Court for the Central District of Illinois (App. 11-24)[1] is reported at 692 F. Supp. 918. The opinion of the United States Court of Appeals for the Seventh Circuit (App. 1-10), which affirmed the decision of the district court, is reported at 882 F.2d 229. The order of the court of appeals denying rehearing and rehearing in banc (App. 26) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 10, 1989. The order denying rehearing and rehearing in banc was entered on October 25, 1989. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1254(1).

STATUTORY PROVISIONS INVOLVED

Section 302(c)(3) of ERISA, 29 U.S.C. §1082(c)(3) and section 412(c)(3) of the Internal Revenue Code of 1954 ("Code"), 26 U.S.C. §412(c)(3) contain identical standards for selection of actuarial methods and assumptions under employee benefit plans. Code §404(a)(1), 26 U.S.C. §404(a)(1) permits an income tax deduction for contributions to a tax-qualified pension plan in an amount determined using actuarial assumptions and methods selected under the standards set forth in ERISA §302(c)(3) and Code §412(c)(3). ERISA §3(21)(A) sets forth the definition

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[1] References to "App." pages are to the Appendix to this Petition.

of "fiduciary", and ERISA §404(a)(1), 29 U.S.C. §1104(a)(1) contains fiduciary responsibility provisions relevant to the standard of review question. These statutory provisions are set forth in the Appendix (App. 26-30).

STATEMENT OF THE CASE

A. The Plan.

Effective January 1, 1980 Jerome Mirza & Associates, Ltd. ("Corporation") established the Jerome Mirza & Associates, Ltd. Defined Benefit Pension Plan and Trust ("Plan").[2] Each Plan participant accrued a benefit of 30% of compensation in 1980, reduced by certain social security benefits, and payable annually for life commencing when the participant attained age 55 and completed 10 years of Plan participation.

The Plan provided substantial ancillary benefits, payable upon early retirement, disability, termination of employment and death, which obligated the Plan to pay the actuarial equivalent[3] of a participant's accrued benefit

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[2] The plan is a defined benefit plan under which the benefits to be received by the participants are fixed, and the Corporation's contributions are adjusted to whatever level is necessary to provide those benefits. *Nachman Corp. v. PBGC*, 446 U.S. 359, n. 5 (1980).

[3] One form of a plan benefit (*e.g.*, an amount payable annually for life) is actuarially equivalent to another form (*e.g.*, a lump sum) if both benefits have the same present value. *See*, C.L. TROWBRIDGE and C.E. FARR, *THEORY AND PRACTICE OF PENSION FUNDING* 18-9 (1976).

in a lump sum prior to a participant's normal retirement date. The Plan also permitted a Plan participant to borrow the lump sum value of a participant's accrued benefit. The lump sum value of the Plan's ancillary and borrowing benefits was determined using the discount rate of 5% specified by the actuarial equivalency definition in the Plan.[4] The Internal Revenue Service ("Service") issued a favorable determination letter finding that the Plan and its ancillary benefits were qualified under the federal tax laws.

B. Selection of Actuarial Assumptions.

The Plan's enrolled actuary[5] selected the unit credit actuarial cost method to value the Plan's assets and liabilities so that the Plan's benefits would be funded at the time the benefits were accrued. The actuarial cost method is a mathematical model used to determine the amount and incidence of the annual cost of plan benefits and expenses. The unit credit method, also called the accrued benefit cost method, is one of six acceptable cost methods under ERISA. ERISA §3(31), 29 U.S.C. §1002(31). Under the unit credit cost method, a plan's normal, that is,

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[4] Revenue Ruling 79-90, 1979 C.B. 155-6, required that the Plan define "actuarial equivalent", and the Plan defined actuarial equivalency as based on 5% interest per year.

[5] ERISA requires that the level of contributions necessary to fund benefits promised by a defined benefit pension plan be selected by an actuary enrolled with the Joint Board for the Enrollment of Actuaries. ERISA §3042, 26 U.S.C. §1242. Mr. Joseph Beres, Jr., an enrolled actuary with The Wyatt Company, acted as the Plan's actuary in 1980.

deductible, cost is typically the cost of benefits credited or accrued based on compensation for the current year.[6]

The plan actuary conducted a thorough review of pertinent factors in selecting actuarial assumption for the Plan in 1980. The actuary knew, based on historical surveys of professional money managers conducted by his actuarial firm, The Wyatt Company, that professional money managers had achieved returns of 3.2% and 5.5% on equities and fixed income funds, respectively, for pension plans over the prior twelve years.[7] The actuary's experience indicated that non-investment professionals, such as the Plan's trustee,[8] who were investing plan funds were achieving returns of about 5% per year. Further, the Plan's ancillary benefits could require the Plan to pay the full lump sum value of accrued benefits based on an actuarial equivalency of 5% upon a participant's death, disability, early retirement or termination

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[6] Bureau Bulletin on 23(p)(1)(A) and (B), Part III (D) (1945), reprinted in CCH PENSION PLAN GUIDE PRE-1986 IRS TAX RELEASES OTHER THAN REVENUE RULINGS 1; C.L. TROWBRIDGE and C.E. FARR, THEORY AND PRACTICE OF PENSION FUNDING, 35-7 (1976).

[7] The Wyatt Company study is confirmed by a study of the investment performance of ERISA plans conducted for the Department of Labor in 1986, Berkowitz, Logue & Assoc., Inc., *Study of the Investment Performance of ERISA Plans Prepared for the Office of Pension and Welfare Benefits of the Department of Labor* (July 1, 1986). This study concluded that the mean annual percentage rate of return on 345 ERISA plans from 1968 to 1980 ranged from a high of 20.22% in 1980 to a low of -20.26% in 1974. The equivalent annual rate of return of the means from 1968 to 1980 was 5.27%.

[8] The Plan's trustee in 1980 was Mr. Jerome Mirza, a trial attorney who had no previous investment experience.

of employment. The actuary knew that in volatile investment markets such as those prevailing in 1980, an investor could lose money on sound investments. At the end of 1980 the Plan's investment fiduciary had invested some plan assets in short-term certificates of deposit yielding about 12% per year, but had not decided how to invest the Plan's assets over the long term. Based on these factors, and having no reason to believe that the Plan's investment fiduciary would out-perform the long-term averages obtained by professional money managers, the Plan's actuary selected an interest rate assumption of 5% to be used in valuing the Plan's liabilities.

C. The 1980 Plan Valuation, Contribution and Audit.

The actuary prepared an actuarial valuation of the Plan as of December 31, 1980 using his selected actuarial cost method and assumptions. The valuation reported that the Plan's normal cost (the amount required to be contributed to the Plan in respect of 1980) as $625,925, the single sum value of the benefits which has accrued under the Plan in 1980.[9] The Corporation made contributions

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[9] The valuation report reflected the following benefit accruals and single sum values for benefits accrued under the Plan in 1980:

Participant	*Benefit Accrued*	*Single Sum Value*
Mr. Mirza	$80,927	$619,925
Mr. Dorris	1,215	6,000
Total		$625,925

totalling $618,007 to the Plan in respect of 1980,[10] and deducted the contributions for income tax purposes. The Internal Revenue Service ("Service") audited the Corporation's 1980 tax return and decreased the deduction for the Corporation's Plan contribution to $115,924.[11] The Corporation paid the resulting tax and interest and, after the Service denied its refund claim, brought this action for refund of the tax and interest paid.

SUMMARY OF ARGUMENT

Defined benefit pension plans directly affect "the continued well-being and security of millions of employees and their dependents".[12] ERISA §2(a), 29 U.S.C. §1001(a). In adopting ERISA, Congress moved to "improv[e] . . . the soundness of such plans by requiring them . . . to meet minimum standards of funding . . . ". ERISA §2(c), 29 U.S.C. §1001(c). Recognizing that the

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[10] The Corporation made a partial contribution to the Plan in September 1980, and the Plan's normal cost was reduced from the single sum value of accrued benefits at December 31, 1980 ($625,925) to take into account actuarial earnings on the September contribution.

[11] The Service claimed that in determining the amount deductible in 1980 only the cost of accruals of annual benefits up to $11,062.50 could be attributed to normal cost, and that a pre-retirement interest rate assumption of 8% should have been used.

[12] In 1985 there were 224,474 private defined benefit pension plans in the United States, having a total of about 39,692,000 participants. UNITED STATES DEPARTMENT OF LABOR, TRENDS IN PENSIONS 350 (1989).

selection of actuarial assumptions and methods "are crucial to adequate funding of a plan" (Material Explaining H.R. 12906 Together with Supplementary Views, 93d Cong. 2d Sess. (February 25, 1974)), Congress provided that a plan's costs and liabilities would be determined using reasonable actuarial assumptions and methods independently selected by the plan's actuary, and constituting *"the actuary's* best estimate of anticipated experience under the plan." ERISA §302(c)(3), 29 U.S.C. §1082(c)(3); Code §412(c)(3), 26 U.S.C. §412(c)(3) (emphasis supplied).

To protect the interests of plan participants and their beneficiaries, Congress provided that persons holding discretionary positions with respect to a plan would serve as fiduciaries to the plan. ERISA Sec. 3(21)(A), 29 U.S.C. Sec. 1002(21)(a). Since ERISA imposes discretionary responsibility on the enrolled actuary to select "the single set of actuarial assumptions . . . required for all purposes" (H.R. Rep. 93-1280, 93d Cong. 2d Sess. 285 (August 12, 1974)) under a defined benefit pension plan, Congress clearly intended that the "actuaries performing these plan services will fall within the definition of fiduciary". Material Explaining H.R. 12906 Together with Supplemental Views, 93d Cong. 2d Sess. (February 25, 1974). The actuary's assumptions and methods directly control the amount of money which the plan sponsor is required to contribute to the plan, with the result that the actuary has "discretionary authority or discretionary responsibility in the administration of such plan." ERISA §3(21)(a)(iii), 29 U.S.C. §1002(21)(a)(iii).

The responsibilities of fiduciaries under ERISA "reflect Congress' policy of 'assuring the equitable character' of the plans." *Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U.S. 559, 570 (1985). This Court has held that courts are to develop a federal common law of rights and obligations under ERISA-regulated plans guided by the principles of trust law. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. ___, 103 L.Ed.2d 80, 92 (1989). "Trust principles make a deferential standard of review appropriate when a trustee exercises discretionary powers." *Id.*, citing RESTATEMENT (SECOND) OF TRUSTS §187 (1959). Since actuarial assumptions and methods are, at the mandate of Congress, determined at the discretionary responsibility of the independent plan actuary, the selected assumptions and methods should be reviewed with deference to the assumptions selected by the plan actuary.

The district court reviewed the reasonableness of the actuary's selected assumption and method as a question of fact, and conducted a *de novo* review of underlying factors to determine whether the actuary "engaged in reasonable assumptions to determine the level of funding necessary to provide the plan's projected benefits". App. 20-3. The court of appeals reviewed an actuary's selected method and assumptions as a question of fact on which the district court's decision would not be reversed unless clearly erroneous. App. 4. Neither the district court nor the court of appeals addressed petitioner's argument that the actuary's selected assumptions and methods should be subjected to a deferential standard of review. The standard applied by the courts below would impair the stability of funding for pension benefits by encouraging

claims seeking to redetermine actuarial cost methods and assumptions, and consequently plan funding levels, based on a *de novo* review.[13]

The court of appeals' decision conflicts with the recent decision of the Ninth Circuit Court of Appeals in *British Motor Car Distributors, Ltd.*, 882 F.2d 371 (9th Cir. 1989),[14] which concluded that, in view of "the general ERISA rule of deference to fiduciary decision-making", Congress did not intend to "allow courts to substitute their judgment for the judgments of fiduciaries on decisions involving actuarial rates". *Id.*, at 376; *see, Board of Trustees, Michigan United Food and Commercial Workers Unions v. Eberhard Foods, Inc.*, 831 F.2d 1258, 1261 (6th Cir. 1987) ("The statute [29 U.S.C. §1393] does not anticipate that the actuary will always choose the figure the court would choose as the most reasonable from among the range. Rather, the only requirement is that in every case

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[13] Under the standard applied by the court of appeals' decision, the actuarial method and assumptions for a defined benefit pension plan would, if questioned by a sponsoring employer or by the Internal Revenue Service as producing too high a contribution level, or by plan participants as producing too low a contribution level, be redetermined by a judge or jury without any deference to the assumptions originally selected by the plan's actuary.

[14] While the *British Motor Car Distributors, Ltd.* court did not review actuarial assumptions in response to a challenge from the Service, the court did review the "single set of actuarial assumptions . . . required for all purposes." H.R. Rep. No 93-1280, 93d Cong. 2d Sess. 285 (Aug. 12, 1974). That single set of assumptions should be reviewed under the same standard for all purposes.

the actuarial determination will fall within the range of reasonableness – taking into account the unique characteristics of the fund.")

ARGUMENT

A. ERISA's Minimum Funding Standards.

ERISA is a "comprehensive and reticulated"[15] statute that was enacted after more than a decade of studying the nation's employee benefit plans. *Nachman Corp. v. Pension Benefit Guaranty Corp.*, 446 U.S. 359, 361 (1980). Recognizing that employers need not provide any employee benefits, Congress struck a balance in the statute between regulating existing benefit plans and tempering that regulation to encourage the development of new plans and the continuation and expansion of existing ones. *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 107 S. Ct. 2211, 2217 (1987); *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504, 515 (1981). One of Congress' principal purposes in adopting ERISA, was to assure that if a participant had "been promised a defined pension benefit upon retirement, and if he has fulfilled whatever conditions are required to obtain a vested benefit, he actually will receive it." *Nachman Corp. v. Pension Benefit Guaranty Corp.*, 446 U.S. 359, 375 (1980).

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[15] *Nachman Corp. v. PBGC, supra,* at 361. Title I of ERISA, §2 *et seq.*, 29 U.S.C. §1001 *et seq.*, mandates minimum funding schedules for qualified plans and establishes standards of conduct for plan fiduciaries. Title II, ERISA §1001 *et seq.*, amended various provisions of the Internal Revenue Code of 1954 pertaining to qualification of pension plans for special tax treatment to conform to the standards set forth in Title I. *Id.* at n. 1.

Congress employed the statutory concept of a "minimum funding standard" to assure that pension plans were adequately funded. ERISA §302, 29 U.S.C. §1082); Code §412, 26 U.S.C. §412. ERISA's minimum funding standards generally require a sponsoring employer of a defined benefit pension plan to annually contribute, at a minimum, the "normal cost" of the plan plus amortization of past service liabilities, experience losses, and the like. H.R. Rep. No. 93-1280, 93d Cong. 2d Sess. 283 (August 12, 1974). Congress repeatedly recognized, and did not intend to change, the requirement of pre-ERISA law that a contribution to a defined benefit pension plan be large enough to pay the plan's normal cost, which Congress described as "the pension liabilities created in the current year" and "the costs attributable to the current operation of the plan".[16]

B. Independent Selection of Actuarial Method and Assumptions.

In estimating pension costs, actuaries must make assumptions about a number of future events, such as the rate of interest, employees' future earnings and employee mortality and turnover, and must select an actuarial method to calculate plan liabilities and costs. Since the amounts required to fund any given pension plan can vary significantly according to the mix of these actuarial

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[16] S. Rep. No. 93-383, 93d Cong. 1st Sess., 3 (Aug. 21, 1973); H. R. Rep. No. 93-779, 93d Cong. 2d Sess., 23 (Feb. 5, 1974); Material Explaining H.R. 12906 Together with Supplementary Views, 93 Cong. 2d Sess. (Feb. 25, 1974); S. Rep. No. 93-127, 93d Cong. 1st Sess., 9-10 (April 18, 1973).

assumptions and methods, "the assumptions and methods used by actuaries are basic to the application of minimum funding standards for defined benefit pension plans." S. Rep. No. 93-383, 93d Cong. 1st Sess. 68 (Aug. 21, 1973).

Congress was aware that "frequently there is a range of actuarial assumptions which may be appropriate for determining the costs of a defined benefit pension plan," and intended that the appropriate actuarial method and assumptions for a defined benefit pension plan would be "very much a matter of judgment" for the plan's enrolled actuary.[17] H.R. Rep. No. 93-779, 93d Cong. 2d Sess. 94 (February 5, 1974). Congress provided in ERISA for a new class of "enrolled actuary" to provide services to pension plans. ERISA established the Joint Board for Enrollment of Actuaries ("Joint Board") (ERISA Sec. 3041, 26 U.S.C. Sec. 1241), and empowered the Joint Board to "establish reasonable standards and qualifications for persons performing actuarial services with respect to which [ERISA] applies". ERISA §3042, 26 U.S.C. §1242. The Joint Board has adopted regulations which require that an enrolled actuary "exercise due care, skill, prudence and diligence" in carrying out his duties to an ERISA plan. 20 C.F.R. §901.20(e).

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[17] Congress considered "establish[ing] the specific actuarial assumptions and methods that could be used by pension plans", but rejected that approach because "any attempt to specify actuarial assumptions and funding methods for pension plans would in effect place these plans in a straightjacket so far as estimating costs is concerned, and would be likely to result in cost estimates that are not reasonable." H.R. Rep. No. 93-807, 93d Cong. 2d Sess. 27 (February 21, 1974).

Under both ERISA and the Code, all costs, liabilities, rates of interest and other factors used for funding purposes are to be determined on the basis of actuarial assumptions and methods which, in the aggregate, are "reasonable" and which, in combination, "offer *the actuary's* best estimate of anticipated experience under the plan." ERISA §302(c)(3), 29 U.S.C. §1082(c)(3); Code §412(c)(3), 29 U.S.C. §412(c)(3) (emphasis supplied). Congress intended that "a single set of actuarial assumptions will be required for all purposes" including ERISA's minimum funding standard, which determines the minimum amount which an employer must contribute to a plan each year and the amount deductible by the employer for tax purposes, and reporting to participants and beneficiaries. H.R. Rep. No. 93-1280, 93d Cong. 2d Sess. 285 (August 12, 1974). Congress thus delegated to the independent enrolled actuary the discretion to determine the actuarial assumptions and methods to be used in determining the funding cost of a defined benefit pension plan.

C. Fiduciary Status of Plan Actuary.

To protect the interests of plan participants and their beneficiaries, Congress provided that any person who "has any discretionary authority or discretionary responsibility in the administration" of a plan would serve as a fiduciary to the plan. ERISA §3(21)(A)(iii), 29 U.S.C. §1002(21)(a)(iii). ERISA's legislative history establishes that an actuary who selects actuarial assumptions and methods for a defined benefit pension plan was intended by Congress to be subject to ERISA's fiduciary rules. The

House report accompanying H.R.12906[18] noted the expanded coverage of the fiduciary rules to "a broad range of persons dealing with these funds", and expressly stated "the clear intention that any person with a specific duty imposed on him by this statute be deemed to be a fiduciary."[19] Since the "assumptions utilized in determining plan liabilities and assets and the choice of appropriate valuation and funding methodology are crucial to adequate funding of a plan", Congress intended that the "actuaries performing these plan services will fall within the definition of fiduciary". Material Explaining H.R. 12906 Together with Supplemental Views, 93d Cong. 2d Sess. (February 25, 1974).

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[18] H.R.12906 introduced the expanded definition of fiduciary which was ultimately adopted as ERISA §3(21). H.R.12906, 93d Cong. 2d Sess. §3(21).

[19] The Committee has adopted the view that the definition of fiduciary is of necessity broad and it intends to impose strict duties on those whose activities bring them within the definition. A fiduciary need not be a person with direct access to the assets of a plan nor is there any requirement of a written or other formal acknowledgment of fiduciary status. Conduct alone may in an appropriate circumstance impose fiduciary obligations. It is the clear intention of the Committee that any person with a specific duty imposed on him by this statute be deemed to be a fiduciary. This is a departure from current judicial precedents but is necessary to the proper protection of these plans.

Employee Benefit Security Act of 1974; Material Explaining H.R. 12906 Together with Supplemental Views, 93d Cong. 2d Sess.

D. Standard for Review of ERISA Fiduciary Decision.

ERISA "abounds with the language and terminology of trust law." *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. ___, 103 L.Ed.2d 80, 92 (1989). This Court has held that courts are to develop a federal common law of rights and obligations under ERISA plans, "guided by principles of trust law." *Id.* Reports on both the House and Senate bills leading up to ERISA stated that "[t]he fiduciary responsibility section . . . codifies and makes applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts."[20] Courts are to develop a federal common law of rights and obligations under ERISA-regulated plans "guided by the principles of trust law." *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. ___, 103 L.Ed.2d 80, 92 (1989). "Trust principles make a deferential standard of review appropriate when a trustee exercises discretionary powers." *Id.*, citing RESTATEMENT (SECOND) OF TRUSTS §187 (1959). Since actuarial assumptions and methods are, at the mandate of Congress, determined at the discretionary responsibility of the independent plan actuary, the selected assumptions and methods should be reviewed with deference to the assumptions selected by the plan actuary.

The judicial standard of review applicable to common law trustees is one of great deference. If a trustee is given discretionary power, a court will not control or veto his exercise of it, instruct him how to use it, or substitute its own judgment for that of the trustee. RESTATEMENT

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[20] H.R. Rep. No. 533, 93d Cong., 1st Sess. 11 (1973); S. Rep. No. 127, 93 Cong., 1st Sess. 29 (1973).

(SECOND) OF TRUSTS §187 (1959); G. BOGERT, TRUSTS & TRUSTEES §394 (2d ed. 1978); III A. SCOTT & W. FRATCHER, THE LAW OF TRUSTS §187 (4th ed. 1988). A court will interfere, however, when a trustee has abused his discretion.[21] An abuse of discretion may be present where a trustee acts beyond the bounds of reasonable judgment. This rule applies where a trustee has discretion regarding the management or investment of trust assets. A trustee must utilize proper care and skill, and must act prudently. RESTATEMENT, *supra*, comment i, at 406; III A. SCOTT, *supra*, §187.2, at 33. Moreover, failure to use any judgment at all constitutes an abuse of discretion.[22] A

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[21] Actions which are dishonest or in bad faith, such as acceptance of a bribe, are one example of conduct which is an abuse of discretion. RESTATEMENT, *supra*, comment f, at 403; III A. SCOTT, *supra*, §187.4, at 44-45. Actions or decisions made with an improper motive, such as spite, prejudice or furtherance of some interest of the trustee or of a person other than a beneficiary, also constitute an abuse of discretion. RESTATEMENT, *supra*, comment g, at 404; III A. SCOTT, *supra*, §187.5, at 46-47.

[22] For example, a decision made without knowledge or without inquiry is an abuse of discretion, as is an arbitrary decision made at the whim of the trustee. RESTATEMENT, *supra*, comment h, at 405. A trustee might also fail to exercise judgment because of an erroneous belief as to a matter of law. For example, a trustee might refuse to sell trust property due to an erroneous belief that he has no power of sale. III A. SCOTT, *supra*, §187.3, at 43.

trial *de novo* conducted by the court is inappropriate in the trust context.[23]

This Court has ruled that when a plan fiduciary exercises discretion in determining benefit claims under an ERISA plan, the fiduciary's determination must be subjected to a deferential standard of review. *Firestone, Tire and Rubber Company, supra.* Similarly, the courts of appeal have applied a deferential, "procedural prudence", standard of review to discretionary acts by investment

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[23] Relevant factors in evaluating a trustee's conduct are: (1) the extent of discretion intended to be conferred upon the trustee by the terms of the trust; (2) the purposes of the trust; (3) the existence or nonexistence, the definiteness of indefiniteness, of an external standard by which the reasonableness of the trustee's conduct can be judged; (4) the circumstances surrounding the exercise of the trustee's power; (5) the motives of the trustee in exercising or refraining from exercising his power; and (6) the existence or nonexistence of an interest in the trustee conflicting with that of the beneficiaries. RESTATEMENT, *supra,* comment d, at 403; III A. SCOTT, *supra,* §187, at 15. In reviewing a trustee's actions or decisions, a court must consider only the circumstances present at the time the action or decision took place, not the circumstances present at a subsequent time when his conduct is being questioned. RESTATEMENT, *supra,* §174, comment b, at 379, §227, comment o, at 535; G. BOGERT, *supra,* §541, at 159. "[I]t is by no means just for a judge to say, after bad consequences have arisen from an act done by a person exercising fiduciary powers, that he should have foreseen what subsequently happened, and therefore be held guilty of a breach of trust. If he did not foresee what no person of ordinary foresight, standing in his place, could have foreseen, he has violated no duty, and incurred no liability." G. BOGERT, *supra,* §541, at 163.

fiduciaries under ERISA.[24] As to the review of plan investment decisions, which are also made under ERISA's prudence requirements, the cases are clear that the test of prudence is whether, at the time the fiduciary engaged in the challenged transaction, the fiduciary employed appropriate methods to investigate the merits of the investment and to structure the investment. *See, e.g., Donovan v. Mazzolla*, 716 F.2d 1226, 1232 (9th Cir. 1983), *cert. den.* 464 U.S. 1040 (1984) (the court's task is to inquire "whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment."); *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir. 1984), citing *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983) ("courts have focused the inquiry under the 'prudent man' rule on a review of the fiduciary's independent investigation of the merits of a particular investment."); *Donovan v. Walton*, 609 F. Supp. 1221, 1228 (S.D. Fl. 1985) ("The [prudence] analysis considers the trustees' *conduct* and not the success or failure of the investment."); *Marshall v. Glass/Metal Association*, 507 F. Supp. 378 (D. Haw. 1980) ("ERISA does not require that a pension fund take no risks with its investments. Virtually every investment entails some degree of risk, and even the most carefully evaluated investments can fail while unpromising investments may succeed."); *cf., Leigh v. Engle*, 727 F.2d 113, 124 (7th Cir. 1983). Similarly, the inquiry under the "prudent

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[24] As a fiduciary under ERISA and as an actuary enrolled with the Joint Board, an actuary exercises discretion and is required to exercise due care, skill, prudence and diligence. ERISA §404(a), 29 U.S.C. §1104(a); 20 C.F.R. §901.20(c).

man" rule on a review of an actuary's selected assumptions and methods should focus on the actuary's independent investigation of the merits of a particular decision, rather than on an evaluation of the merits alone.

In *British Motor Car Distributors, Ltd., supra,* The Ninth Circuit considered claims brought under ERISA by employers contending that surplus assets in a welfare plan had resulted from certain actuarial errors and should be returned to the employers as resulting from contributions made under a "mistake of fact".[25] In rejecting the employer's claims, the Ninth Circuit held:

> Actuarial projections involve making estimates about future claims. Because future claim levels are a function of numerous contingencies, and plan fiduciaries are required under ERISA to ensure that their plan has the assets to cover future claims, it is not uncommon that actuarial projections will produce surplus assets. If employers could challenge fiduciaries' actuarial decision that result in a fund surplus as alleged mistakes of fact under §403(c)(2)(A)(ii), then conceivably every decision of plan fiduciaries having financial consequences would be subjected to attack as a §403(c) mistake of fact. This would be inconsistent with the broader statutory scheme of ERISA because plan fiduciaries act within the scope of their statutorily-assigned

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[25] While the *British Motor Car Distributors, Ltd.* court did not review actuarial assumptions in response to a challenge from the Service, the court did review the "single set of actuarial assumptions . . . required for all purposes." H.R. Rep. No. 93-1280, 93d Cong. 2d Sess. 285 (Aug. 12, 1974). That single set of assumptions should be reviewed under the same standard for all purposes.

> duty when they adopt any "reasonable" set of assumptions and methods.
>
> Moreover, there is nothing in the language of §403(c)(2)(A)(ii) or its legislative history to suggest that Congress intended by this provision to deviate from the general ERISA rule of deference to fiduciary decision-making and allow courts to substitute their judgments for the judgments of fiduciaries on decisions involving actuarial rates.

British Motor Car Distributors, Ltd., 882 F.2d 371, 376 (9th Cir. 1989).

Under the proper legal standard, an enrolled actuary's selected actuarial assumptions and method must be reviewed with deference. A court should review the investigation undertaken by the actuary in selecting the method and assumptions and, if the investigation was procedurally prudent, the court should not set aside actuarial assumptions and methods which were reasonably indicated by the results of the actuary's investigation.

E. Determination of Deductible Contribution.

An employer is generally entitled to a deduction for a contribution paid to a tax-qualified plan in "an amount equal to the normal cost of the plan". Code §404(a)(1)(A)(iii), 26 U.S.C. §404(a)(1)(A)(iii). The funding method and actuarial assumptions used in determining the amount deductible under Code §404 are the same as those used under Code §412. Code §404(a)(1)(A). Thus, the deductible "normal cost" of a defined benefit plan is determined using the single set of actuarial assumptions that are to be used for all plan purposes.

Congress intended that the Service's review of actuarial methods and assumptions would be subject to ERISA's general rule of deference to fiduciary decision-making. While Congress expected the Service, on audit, to require a change of actuarial assumptions which are not "reasonable in the aggregate", Congress explained that "unless the assumptions used are substantially unreasonable, it is contemplated that generally the Service will not require a change of assumptions to be made effective for years prior to the year in which the audit is made." H.R. Rep. No. 93-779, 93d Cong. 2d Sess. 94 (February 5, 1974). In this case, the Service's audit was conducted more than three years after the end of the 1980 Plan year, and no finding has been made that the actuary's selected assumptions were "substantially" unreasonable.

F. The Cost of Benefits Accrued Under the Plan in 1980 Was Properly Allocated to Normal Cost Under the Unit Credit Cost Method.

When Congress adopted ERISA, Congress repeatedly recognized, and did not intend to change, the effect of pre-ERISA law that required an employer to contribute – and permitted the employer to deduct for income tax purposes – the normal cost of a defined benefit pension plan, which Congress described as "the pension liabilities created in the current year" and "the cost attributable to the current operation of the plan".[26] Congress considered,

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[26] S. Rep. No. 93-383, 93d Cong. 1st Sess. 3 (Aug. 21, 1973); H.R. Rep. No. 93-779, 93d Cong. 2d Sess. 23 (Feb. 5, 1974);

(Continued on following page)

but squarely rejected, proposals which would have limited early benefit accruals by private pension plans.[27] Congress intended that private parties, and not the government, would control the level of benefits under qualified plans. *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504, 506 (1983). ERISA does not prohibit the early accrual of benefits provided by the Plan, and intends that the cost of benefit accruals be contributed – and deducted for income tax purposes – in the year the benefits are accrued under the Plan.

Treasury regulations confirm that normal cost under a reasonable funding method can be expressed as "an amount equal to the present value of benefits accruing under the method for a particular plan year". Treas. Reg. §1.412(c)(3)-1(B)(2)(ii). In adopting those regulations, Treasury discussed that 'the best rule, theoretically" for allocating liabilities under the unit credit funding method was to allocate benefit accruals "in proportion to the applicable rates of benefit accrual under the plan". Treas. Reg. §1.412(c)(3)-1(e)(3); 45 F.R. 86429 (December 31, 1980). The Plan's 1980 valuation calculated the 1980

(Continued from previous page)

Material Explaining H.R. 12906 Together With Supplementary Views, 93d Cong. 2d Sess. (Feb. 25, 1974); S. Rep. No. 93-127, 93d Cong. 1st Sess. 9-10 (Apr. 18, 1973).

[27] The Conference Committee on ERISA commented that "[t]hus, (unlike the House bill) the conference substitute permits an unlimited amount of 'front loading' under this [133 1/3] test." H.R. Rep. No. 93-1280, 93d Cong. 2d Sess. 274 (Aug. 12, 1974).

normal cost as the present value of the benefits accrued under the Plan that year, and followed Treasury's theoretically correct rule. The only expert witness who testified on this issue at trial was Mr. Donald S. Grubbs, an expert for the government and former chief of the Service's actuarial branch and the first chairman of the Joint Board for Enrollment of Actuaries. Mr. Grubbs testified that the Plan's actuary had properly calculated the Plan's normal cost in 1980 as the cost of all benefits accrued under the Plan in 1980.

CONCLUSION

This case presents an important and pervasive issue under ERISA as to the standard of review to be applied to an actuary's selected assumptions and methods. The court of appeal's decision in this case conflicts with the standard applied by the Ninth Circuit, and with clear Congressional intent. The failure of the court of appeals to adhere to congressional intent, and the consequent uncertainty that will ensue among employers and plan administrators make review by this Court imperative. The Court should grant the Petition and reverse the judgment of the court below in order to restore order, uniformity, and reason to the law governing employee benefit plans.

Dated: January 22, 1990

Respectfully submitted,

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Counsel for Petitioner

No. _____

In The

Supreme Court of the United States

October Term, 1989

JEROME MIRZA & ASSOCIATES, LTD.,
an Illinois corporation,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

In the
United States Court of Appeals
For the Seventh Circuit

No. 88-2774

JEROME MIRZA & ASSOCIATES, LTD.,
an Illinois corporation,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appeal from the United States District Court
for the Central District of Illinois, Springfield Division.
No. 86-3182-**Richard Mills,** *Judge.*

ARGUED APRIL 4, 1989 – DECIDED AUGUST 10, 1989

Before COFFEY, FLAUM, and RIPPLE, *Circuit Judges.*

FLAUM, *Circuit Judge.* Jerome Mirza & Associates appeals from a district court decision dismissing its claim for a refund of federal income taxes under 26 U.S.C. § 1346(a)(1). For the reasons discussed below, we affirm.

I.

The taxpayer Jerome Mirza & Associates is a professional corporation engaged in the business of providing legal services. In 1980, the taxpayer established a pension plan to provide pension benefits for two of its employees, Jerome Mirza and David Dorris. Under the terms of the plan, which was designed to conform to the requirements

of §§ 401 and 501 of the Internal Revenue Code, each participant accrued a benefit equal to 30% of his compensation for 1980 plus 5% of his compensation for each of the next three years of participation, reduced by the amount necessary to fund social security benefits. This accrued benefit was payable in annual installments on the date the participant reached 55 years of age and completed ten years of participation in the plan.[1] In 1980, Jerome Mirza was 43 years of age and earned $275,000 while Dorris was 33 years of age and earned $27,000. Consequently, under the terms of the plan, Mirza accrued a benefit of $80,927 payable annually for life at age 55 while Dorris accrued an annual benefit of $1,215. At the time that the plan was adopted, Mirza, who was the corporation's sole shareholder, had been employed by the taxpayer for seven years and Dorris had been employed by the taxpayer for five years.

In order to determine the amount of contributions necessary to adequately fund the benefits accrued under the plan, the taxpayer hired enrolled actuary Joseph Beres. Beres chose the unit credit cost method, an accepted actuarial technique, in making his assumptions and determined that a 5% annual return on investment was an appropriate assumption. Employing this figure, Beres calculated the present value of the future benefits under the plan as $625,925. Beres informed the taxpayer that this sum represented the "normal cost" of the plan

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[1] The plan also provided for a lump sum payment of the accrued benefit if the participant retired, became disabled, or died prior to reaching age 55.

and was immediately deductible under 26 U.S.C. § 404(a)(1)(A)(iii).

The taxpayer followed Beres' advice and deducted the entire amount from its federal income taxes for 1980. This deduction created a loss for 1980 which the taxpayer carried back for several years and ultimately resulted in a refund of $235,731. The Commissioner, however, audited the taxpayer's 1980 return and substantially reduced the allowable deduction. Initially, the Commissioner determined that the actuary's 5% interest rate assumption was not reasonable within the meaning of 26 U.S.C. § 412(c)(3) in view of the abnormally high interest rates prevalent in 1980 and substituted its own figure of 8%. Accordingly, the Commissioner reduced the single sum present value of the accrued benefits under the plan from $625,925 to $442,010. In addition, the Commissioner apportioned this amount between the cost attributable to service in 1980 (which he deemed to be the normal cost of the plan) and that attributable to the participant's past service (which under § 404(a)(1)(A)(iii) had to be amortized over a ten year period). This allocation reduced the taxpayer's deduction in 1980 to $115,953.71 which in turn increased the taxpayer's tax liability by $227,415. The taxpayer paid this amount plus interest of $193,950 and sued for a refund under 26 U.S.C. § 1346(a)(1).

The district court conducted a hearing on the question of the reasonableness of the actuary's assumptions, concluded that Beres' 5% interest assumption was not reasonable based on the experience and characteristics of the taxpayer's plan, and upheld the Commissioner's calculation of the present value of the benefits provided by the plan as $442,010. In addition, the district court, on

cross motions for summary judgment, determined that under 404(a)(1)(A)(iii) this figure had to be allocated between the cost of benefits attributable to service in 1980 and the cost of benefits attributable to service in prior years. Accordingly, the district court upheld the Commissioner's determinations in all respects. The taxpayer appeals from this decision.

II.

The initial question on appeal is whether the district court correctly concluded that the actuary's 5% interest rate assumption was not reasonable. The issue of the reasonableness of an actuary's assumptions under § 412 is a question of fact and the district court's decision will not be reversed unless clearly erroneous. *See Board of Trustees, Michigan United Food and Commercial Workers Unions v. Eberehard Foods, Inc.*, 831 F.2d 1258 (6th Cir. 1987). Under the clearly erroneous standard, an appellate court will not disturb a district court's finding unless it is left with the firm conviction that a mistake has been committed. *Shore v. Dandurand*, Nos. 87-3058 and 87-3143 slip op. at 8 n.9 (7th Cir. May 31, 1989).

In our view, the district court's findings were not clearly erroneous. At trial, there was conflicting expert testimony on the question of reasonableness. Plaintiffs' witnesses concluded that because the plan's principal beneficiary who was 43 years of age at the time the plan was instituted intended to retire at age 55, the relevant time period for making the actuarial assumptions was twelve years and testified that pension plans earned approximately 5% on their investments in the twelve-year

period 1968-1980. In addition, these witnesses testified that actuaries, fearing personal liability if the plan ultimately proves to be inadequately funded, are generally very conservative in making their assumptions.

Not surprisingly, the government's witnesses took a different view of the reasonableness of the actuary's assumptions. The government's witnesses noted that under § 412(c)(3), the reasonableness of an actuary's assumptions must be evaluated in light of the plan's experience and reasonable expectations and testified that an interest rate assumption of 5% was simply not reasonable when these factors were taken into account. In particular the government's witnesses testified that at the time the valuation was made, interest rates on certificates of deposit ranged between 11.65% and 15.75% and were approximately 12% for long-term (*i.e.*, 10 and 20 year) certificates. In addition, the government's witnesses noted that at the time Beres made his calculations the plan had already invested $300,000 in short-term certificates of deposit and contended that this information should have alerted the actuary to the type of investment the plan preferred *i.e.*, conservative investments. Finally, the government's witnesses emphasized that under the terms of the plan most of the accrued benefits were to be funded within four years of the actuary's valuation. Given these facts, the government's witnesses testified that an interest rate assumption of 7-10% would have been reasonable.

As noted above, we will not reverse the district court's decision unless we are left with the firm conviction that an error has been committed. On the facts of this case we are unable to reach this conclusion. In view of the

structure of the funding of the plan and its history of investments there is abundant evidence in the record supporting the government's position that an 8% rate of interest was appropriate. Conversely, there was ample evidence adduced at trial indicating that the actuary's 5% interest rate assumption was not reasonable given the peculiarities of the taxpayer's plan. In particular, the actuary's reliance on the long-term returns on investments by large-scale pension plans was unsound given the fact that the taxpayer's plan was very small and would be fully funded over a very short period. Moreover, by relying on information which included substantial investments in the stock market, the actuary ignored the experience of the taxpayer's plan which had shown no inclination to make these types of investments. Given these facts, we are unable to conclude that the district court's decision was clearly erroneous.

III.

Having determined that the government properly reduced the taxpayer's allowable deduction from $625,925 to $442,010, we must next decide whether the taxpayer could deduct this entire amount in 1980 or was required to spread the deduction over several years. The resolution of this issue depends upon our construction of § 404(a)(1)(A)(iii) of the Internal Revenue Code as it existed in 1980 in light of other relevant provisions and regulations. In that year, § 404(a)(1)(A)(iii) granted employers a deduction for contributions to a qualified pension plan in an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Secretary, plus if past service or other supplementary

pension or annuity credits are provided by the plan, an amount necessary to amortize such credits in equal annual payments (until fully amortized) over 10 years.

The dispute in this case centers on the meaning of the term "normal cost." The taxpayer asserts that normal cost is defined as "an amount equal to the present value of benefits accruing under the method for a particular plan year," Treas. Reg. § 1.412(c)(3)-1(b)(2)(ii) (1981), and argues that since the plan was structured to provide benefits based on compensation earned during 1980, the entire amount of these benefits accrued during that year. In addition, the taxpayer argues that while subsequent developments have eliminated the possibility of employers taking such a large deduction in the first year of a plan's existence,[2] nothing in either the Internal Revenue Code or published guidance available in 1980 cast doubt upon its method. At its most elemental level, therefore, the taxpayer's argument is that it took advantage of a loophole in the federal tax laws in 1980.

The government does not dispute that the normal cost of a plan is defined as the cost of benefits accruing during the particular year. Rather, the government argues that the benefits provided by the taxpayer's plan did not all accrue in 1980. In the government's view, § 404(a)(1)(A)(iii) should not be read in isolation but must be interpreted in conjunction with § 415(b), the provision that limits the annual benefits payable to a participant in

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[2] In 1985, the Service issued Revenue Ruling 85-131 which explicitly held that under the unit credit cost method the costs of benefits must be apportioned between service in the present year and service in past years.

a qualified plan. In 1980, § 415(b) limited the annual benefit payable to a highly compensated employee like Jerome Mirza to the following amount: $110,625 x employee's years of service divided by ten.[3] Thus, a highly compensated employee without prior service was limited to a maximum annual benefit of $11,062. As noted above the taxpayer's plan provided Jerome Mirza with an annual benefit of over $80,000, a benefit that was only possible due to Mirza's seven years of service to the taxpayer. The government argues that in view of the fact that the level of benefits paid by the plan is attributable in large measure to Mirza's service in years prior to 1980, it was not reasonable for the taxpayer to attribute the cost of funding those benefits solely to 1980. Rather, the government asserts that the taxpayer was required to take his past service into account in taking a deduction under § 404(a)(1)(A)(iii) by allocating a substantial portion of the cost of funding the plan's benefits to past service credits. This allocation in turn would require the taxpayer to deduct the cost of funding these past service credits over a ten year period.

The guiding principle in this case is that deductions are extensions of legislative grace and not matters of right. *Colonial Savings Association and Subsidiaries v. Commissioner*, 854 F.2d 1001, 1006 (7th Cir. 1988), *cert. denied*, 109 S. Ct. 1556 (1989). Accordingly, "a deduction from income for tax purposes may be taken only when support

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[3] In 1980, § 415(b) restricted the maximum annual benefit payable to a participant in a qualified plan to the lesser of $110,625 or the participant's average compensation over a three year period.

for it can be found in the language of a statute, appurtenant regulations, or legislative history. *Hintz v. Commissioner*, 712 F.2d 281, 284 (7th Cir. 1983). The taxpayer bears the burden of proving that it is entitled to take a deduction, and the Commissioner's determinations are presumed to be correct. *Colonial Savings Association*, 854 F.2d at 1006.

In our view, the taxpayer has failed to establish that it was entitled to deduct the entire cost of funding the pension plan's benefits in 1980. At the outset, we note that the taxpayer's method of allocating all the costs of funding benefits to normal cost is not supported by any authority. The taxpayer has cited no legislative history and we have been unable to find any that approves its method of deducting the entire cost of funding pension benefits in the first year of a plan's existence. Further, there are no Treasury regulations or revenue rulings that support the taxpayer's position. Most importantly, by upholding the taxpayer's deduction we would effectively eliminate the last part of § 404(a)(1)(A)(iii) which provided for the amortization of the cost of past service credits. It is simply inconceivable that Congress would take pains to provide for the amortization of past service credits but intended to allow taxpayers to circumvent this requirement by the device of structuring their plans to accrue benefits in a single year.[4] Moreover it is equally

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[4] The taxpayer places substantial reliance on the fact that Congress permitted employers to pay benefits based primarily on income earned during the early years of a plan's existence ("front-loading") while it explicitly prohibited the payment of

(Continued on following page)

implausible that Congress intended to allow taxpayers to derive benefits from past service under § 415 while ignoring this past service when it would not be beneficial.

In sum, we find that the taxpayer has not met its burden of demonstrating that it was entitled to deduct the entire cost of funding the participants' pension benefits in 1980. Accordingly, we affirm the Commissioner's allocation of the costs of funding the pension plan between costs attributable to service in 1980 and costs attributable to service in 1980 and costs attributable to service in prior years.

IV.

For all the foregoing reasons the judgment of the district court is affirmed.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

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(Continued from previous page)

benefits based on service in the later years of a plan's existence. That reliance is misplaced. The issue in this case is not whether the plan qualified under §§ 401 and 501 but rather when the deductions may be taken. The fact that Congress authorized a particular structure for a plan does not mean that it authorized an immediate deduction for the entire cost of that plan.

IN THE UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF ILLINOIS –
SPRINGFIELD DIVISION

JEROME MIRZA & ASSOCIATES, LTD., an Illinois corporation,	)	
Plaintiff,	)	No.
v.	)	86-3182
UNITED STATES OF AMERICA,	)	
Defendant.	)	

OPINION

(Filed August 12, 1988)

RICHARD MILLS, District Judge:

> In my own case the words of such an act as the Income Tax . . . merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception – couched in abstract terms that offer no handle to seize hold of – leave in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion . . . that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.
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> L. Hand, *The Spirit of Liberty: Papers & Addresses of Learned Hand*, 213 (I. Dilliard ed. 1960).

A tax case of first impression.

At issue:

(1) Whether 26 U.S.C. §404(a)(1)(A)(iii) required the taxpayer/professional corporation to allocate between current and past service costs the benefits accruing to its sole shareholder in 1980 under a defined benefit pension plan?

(2) Whether the actuarial assumptions the taxpayer/professional corporation utilized in 1980 for the defined benefit pension plan, principally the pre-retirement 5% interest rate assumption, were reasonable in the aggregate as required by 26 U.S.C. §412(c)(3)?

The answers:

(1) Yes

(2) No

BACKGROUND

The taxpayer, Jerome Mirza & Associates, Ltd., is a professional corporation in the business of providing legal services and is controlled by its sole shareholder, Jerome Mirza. On December 31, 1980, the taxpayer adopted the "Jerome Mirza & Associates, Ltd., Defined Benefit Pension Plan" with an effective date of January 1, 1980.

Article I, § A of the Plan states that the taxpayer desired to create a scheme of deferred compensation consistent with §401 of the Internal Revenue Code, and all provisions should be construed so as to comply with the tax code's requirements for qualification. The plan provides, *inter alia*, that an employee is eligible to participate

after three years of service but may accrue benefits only after completing a fourth year of service. Eligible individuals then receive an accrued benefit equal to 30% of the participant's compensation for the first year of participation on or after January 1, 1980, plus 5% of his or her salary for each of the next three years, reduced by 37% of social security benefits ratably earned over the initial four years of plan participation. Each participant is entitled to his or her accrued benefit upon reaching the retirement age of 55 and attaining 10 years of plan participation. The plan also provides that the normal retirement benefit may not exceed the lessor of $110,625 per year or 100% of the participant's total annual income averaged over the high consecutive three years of participation.

The plan covered two employees in 1980. Jerome Mirza had been employed by the taxpayer for seven years and was 43 years old. David Dorris had been employed for five years and was 33 years old. During 1980, Mr. Mirza's compensation totalled $275,000. Mr. Dorris' income was $27,000 of which he elected $9,760 to be considered for pension purposes. Based upon the plan's provisions, the annual accrued benefit was calculated as $80,927 and $1,215 for Mr. Mirza and Mr. Dorris respectively. In other words, upon their retirement at the plan retirement age of 55, Mr. Mirza and Mr. Dorris would receive those respective sums each year even if no benefits accrued in later years.

To fund enough money to pay the yearly benefits, the plan's actuary, the Wyatt Company, then prepared an actuarial valuation report for the plan using the unit credit cost method. The actuarial assumption for the 1980

valuation included an interest rate of 5% for the pre-retirement period. This assumption was the actuary's estimate of the rate the plan would earn on its investments. Because of existing circumstances, mortality, turnover and salary increase assumptions were unnecessary. Employing the actuarial assumptions, the actuary determined the present value of Mr. Mirza's accrued benefit to be $619,925 and Mr. Dorris' to be $6,000. The total of $625,925 was reported as the normal cost for the year. The unfunded past service liability was recorded as zero for the December 31, 1980, valuation.

The taxpayer's 1980 tax return reported a deduction of $625,925 attribution to the pension plan. The amounts contributed in the plan year and how they were invested are as follows:

Date	Amount	Investment
9/15/80	$100,000	6 month CD @ 11.65%
9/15/80	$200,000	36 month CD @ 12.4%
1/5/81	$100,000	6 month CD @ 15.5%
1/8/81	$100,000	6 month CD @ 15.5%
3/3/81	$100,000	6 month CD @ 15.75%
3/3/81	$ 18,007	6 month CD @ 13.861%
	$618,007	
	+ 3,206 –	accrued interest on funds invested prior to 12/31/80
	+ 4,712 –	full funding limitation credit

Tax deduction=$625,925

The corporation's 1980 tax return reported income of $79,038 before the deduction. Following the pension plan deduction, the return reported a loss of $546,887.

Pursuant to 26 U.S.C. §172, the taxpayer carried back the loss and offset it against income earned in 1977, 1978,

and 1979. The carryback generated investment credit for 1974 and 1975 as well. The taxpayer requested and received federal income tax refunds totalling $235,731.

The Internal Revenue Service subsequently audited the corporation's 1980 tax return. Asserting that the 5% interest rate assumption was unreasonable, the IRS first reduced the present value of the accrued pension benefit for 1980 from $625,925 to $442,010 based upon an 8% interest rate assumption. The Service next allocated $63,758.74 of the benefits to normal cost and $378,251 to past service costs. Although the Service agreed that the "normal cost" was currently deductible, it found the tax code required past service costs to be amortized over ten years. Only the amount sufficient to fund a level amortization over ten years was currently deductible. The IRS thus computed the tax deduction to be $115,953.71 (normal cost of $63,758.74 plus past service costs of $52,194.97).

The reduction in the amount of the pension plan's deduction from $625,935 to $115,954 generated a tax increase for the corporation in the amount of $227,415. The taxpayer paid the assessment plus interest of $173,950, the thereafter filed a refund claim which the IRS disallowed.

On June 5, 1986, the taxpayer filed this suit requesting a refund of taxes paid. The Court has jurisdiction pursuant to 28 U.S.C. §1346(a)(1).

ISSUES

A taxpayer seeking a refund under 28 U.S.C. §1346(a)(1) "bears the burden of proving that the

assessment was incorrect and proving the correct amount of the tax owed." *Phil Smidt & Son, Inc. v. National Labor Relations Bd.*, 810 F.2d 638, 642 n.6 (7th Cir. 1987), *quoting, Ray v. United States*, 762 F.2d 1361, 1362 (9th Cir. 1985). *Accord 672 Corp. v. United States*, 461 F. Supp. 445, 447 (N.D. Ill. 1978). The provisions of the Internal Revenue Code which allow for tax deductions are a matter of legislative grace. Such deductions are permitted only to the extent provided by statute. *New Colonial Co. v. Helvering*, 292 U.S. 435, 440 (1933). As the Court stated in *White v. United States*, 305 U.S. 281, 292 (1938): "[A] taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms."

In this instance, the question of whether the Code required an allocation between current and past service costs in 1980 rests purely upon statutory interpretation and may be decided as a matter of law. That issue is the subject of cross-motions for summary judgment under Fed. R. Civ. P. 56. In contrast, whether the actuarial assumptions used to fund the plan were reasonable in the aggregate is a question of fact, the resolution of which must under Fed. R. Civ. P. 52 turn on the evidence adduced at the bench trial heard November 19 and 20, 1987. *See Owensby & Kritikos, Inc. v. Commissioner of Internal Revenue*, 819 F.2d 1315, 1323 (5th Cir. 1987) (question of reasonableness is for the fact-finder). Each issue is discussed *seriatim*.

Issue I

Deductions for contributions to pension plans are controlled principally by 26 U.S.C. §404. In 1980, subsection (a)(1)(A)(iii) placed the following limitation on the amount deductible:

> [A]n amount equal to the normal cost of the plan, as determined under regulations prescribed by the Secretary, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount necessary to amortize such credits in equal annual payments (until fully amortized) over 10 years, as determined under regulations prescribed by the Secretary.

Consistent with the language of the statute, the regulations require that pension plans make a reasonable allocation between past and current service. Treas. Reg. §1.412(c)(3)-1(e)(3) states the general rule: "In determining a plan's normal cost and accrued liability for a particular plan year, the projected benefits of the plan must be allocated between past years and future years." Further, that section provides the allocation between past and future service in a career average pay plan must be reasonable. Because the Plaintiff's plan provides benefits based upon pay in certain plan years, it is a career average type plan and must therefore comply with the command of §1.412(c)(3)-1(e)(3).

The taxpayer correctly points out that §1.412(c)(3)-1 applies only to plan valuations after April 30, 1981. Treas. Reg. §1.412(c)(3)-2(b)(1). But the corporation's argument that the regulation lends no guidance whatsoever is simply wrong. Treas. Reg. §1.412(c)(3)-2(b)(3) provides:

> The reasonableness of a funding method used in making a valuation of a plan's liability as of a date before the effective date determined under subparagraph (1) or (2) of this paragraph is determined on the basis of such published guidance as was available on the date as of which the valuation was made.

Certainly, clear "published guidance" on which the Plaintiff should have relied was available prior to the plan's 1980 valuation. Rev. Rul. 59-67, for instance, required that an employer's contribution under a qualified pension plan made on account of service rendered prior to the year of contribution be considered under 26 U.S.C. §404 as amounts paid to fund the cost of past service credits, despite the fact that the contribution was allocated among participants on the basis of current compensation. Similarly, Treas. Reg. §§1.404(a)-6(a)(2) & (3), in effect at the time of the valuation, refer to the necessary allocation of an accrued benefit under a defined pension plan between current and past service if the benefit was earned due to performance of past services.

The plan's actuary obtained an explanation of the published guidance over a year prior to the valuation date. The actuary requested the IRS to clarify the tax consequences of using the unit credit cost method for funding pension plans which provided front-loaded benefit accruals. The Service responded:

> Under the unit credit method, the allocation of costs between those costs going toward normal costs (current service) and those costs going toward past service liability (past service costs) must be reasonable. Generally costs will not be considered to be current service costs if the benefits accruing in the current year can accrue in

that year only if the participant has adequate past service.

In defending its position, the Government relies heavily on 26 U.S.C. §415. Subsection 415(b)(5) in 1980 provided that the benefits of a participant in a pension plan who has less than ten years of service with the employer cannot exceed the lesser of $110,625 or 100% of the participant's average compensation for his high three years, times the number of years of service divided by ten. Thus, if Jerome Mirza had not had seven years of prior service, §415 would have placed a limitation of $11,062 ($110,625 times 1/10th) on his accrued benefit if the plan were to remain qualified.

Jerome Mirza's ability to accrue a benefit of $80,927 in this case is due solely to his seven years of prior service for his corporation. The §415 limitation is computed including the seven years of prior service as $110,625 times 8/10ths or $88,500. Since Mr. Mirza needs past service to accrue a benefit in excess of $11,062, the taxpayer's allocation of the entire deduction to normal cost under 26 U.S.C. §404(a)(1)(A)(iii) is unreasonable and cannot be sustained. *See* Rev. Rul. 85-131 (allocation of liabilities under the unit credit or accrued benefit method to past and future service must account for the requirements of §415; otherwise, it is not a reasonable funding method). Interpreting the terms of the plan in accordance with the stated desire that it be construed as qualified, requires an allocation to be made between current and past service costs.

The taxpayer asserts that only in 1986 did Congress amend §415 and close the loophole of which it seeks to take advantage. *Au contraire*. Under the 1986 amendment,

subsection (b)(5) limits the accrual of benefits under a qualified plan to 10% of the accrued benefit for each year of participation in the plan. Since the limitation is now based on years of participation, rather than years of service, a plan can no longer utilize service previous to participation to accrue additional benefits. But this is not to say that the former §415 – which permitted Mr. Mirza to accrue benefits of over $80,000 in his first year of participation – allowed the taxpayer to allocate the entire amount to the plan's normal cost and deduct its present value on the employer's 1980 tax return. The issue here is not the amount of the accrued benefit, but the proper allocation between current and past service costs. Jerome Mirza utilized seven years of prior service to accrue his full benefit. The Internal Revenue Service does not attempt to limit that amount, but instead requires the plan to reasonably allocate the benefit between past and present service.

In this Court's view, the amendment to §415(b)(5) did not close a loophole, but rather modified and clarified the law so as to insure proper compliance. To conclude that the tax code let the taxpayer in this instance deduct the entire cost of the plan in a single year would be to reject both the language of §404, and the treasury regulations and revenue rulings previously discussed.

Issue II

The question of whether the actuary engaged in reasonable assumptions to determine the level of funding necessary to provide the plan's projected benefits is governed by 26 U.S.C. §412(c)(3):

> *Actuarial assumptions must be reasonable.* – For purposes of this section, all costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable (taking into the account the experience of the plan and reasonable expectations) and which, in combination, offer the actuary's best estimate of anticipated experience under the plan.

Section 404(a)(1)(A) directs that the amount deductible in any year shall be figured under the assumptions used for §412. *See* Treas. Reg. §1.404(a)-3(b). The reasonableness of the plan's actuarial assumptions largely depends upon two factors: (1) the experience of the plan, and (2) the reasonable expectations of future plan performance.

Because the plan was formed in 1980, no plan experience existed before January 1, 1980. Contributions for that year were invested in short-term certificates yielding 11.65%, 12.4%, 15.5%, 15.75%, and 13.86%. The initial contributions of $200,000 invested in a three-year certificate of deposit at 12.4% and $100,000 invested in a six-month certificate of deposit at 11.65% took place prior to the December 31, 1980, valuation date. Thus, some plan investment experience was present.

This experience is significant for two reasons. First, it illustrates the type of investment the plan would make – very conservative with a high income yield. Oddly enough, the Plaintiff declined to provide the Court with an exhibit projecting CD rates despite its apparent preference for such an investment. Second, the experience indicates the current yields received at the time – between

11% and 15%. The plan investments indicated a much higher return than the 5% assumed by the actuary.

Nor is the 5% assumption a reasonable expectation of the plan's future performance. Accepting Mr. Mirza's age as 43 in 1980 and the actuary's determination of normal retirement age as 55, the investment period for the plan is 12 years. Since the corporation will likely dissolve upon its sole shareholder's retirement and the plan will no longer actively invest, forecasting rates further into the future is unnecessary. According to the evidence proffered at trial, the Treasury Bond rates for the weeks ending December 26, 1980, and January 2, 1981, were as follows:

Week	Ten Year	Twenty Year
12-26-80	12.29%	11.99%
1-2-81	12.36%	12.05%

Consequently, the plan could have invested in 10-year Treasury Bonds and been *guaranteed* a return of over 12% for more than 4/5ths of the pre-retirement investment period. As the Government aptly states: "For individuals who can afford to buy Treasury Bonds, the only reason a prudent investor would not buy them would be due to the belief that they could get a higher yield with other investments!"

Furthermore, under the terms of the plan, 73% of the benefits accrued in the first year, with the remaining 27% accruing over the next three. Given this front-loading of benefits and the short 12-year investment period, one could reasonably expect that the entire cost of the plan could be invested at interest rates well in excess of Plaintiff's 5% "passbook" rate. As shown, a 12% return on 73% of the cost was certain.

The taxpayer's attempt to cloud over the structure of the plan and the 1980 investment outlook must fail. Its reference to 12-year weighted averages of common stock and fixed income funds is misplaced. Not only does the plan's experience indicate that investments in such funds is unlikely, but also the use of the weighted averages is misleading since virtually all of the investments would be made during the initial four years of the plan. Therefore, the taxpayer's use of the 5% assumption is unreasonable.

Admittedly, some plans may balance a conservative interest rate assumption with turnover, compensation or mortality assumptions. But here, no compensating assumptions are present and no adjustment to the rate assumption may be made. In view of the unique features of the taxpayer's plan, reference to other plans is not helpful.

CONCLUSION

Throughout this lawsuit, the taxpayer has asserted that private parties – not the Government – control the level of benefits under a qualified pension plan. But the United States does not attempt to limit the benefits which have accrued to the corporation's employees. Rather, it seeks only a proper determination of *what* the costs of those benefits are and *when* they can be deducted under §404 of the tax code.

Consistent with the foregoing opinion, the Court concludes that the Internal Revenue Service's computation of the allowable deduction to the professional corporation for the costs of the Jerome Mirza & Associates, Ltd., Defined Benefit Pension Plan was proper.

Judgment for the Defendant.

Cause DISMISSED.

Case CLOSED.

ENTER: August 12, 1988.

FOR THE COURT:

/s/ Richard Mills
Richard Mills
United States District Judge

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF ILLINOIS

(Filed AUG 12 1988)

JOHN M. WATERS, Clerk
U.S. DISTRICT COURT
CENTRAL DISTRICT OF ILLINOIS

JEROME MIRZA & ASSOCIATES, LTD.,
an Illinois corporation

v. JUDGMENT IN A CIVIL CASE

UNITED STATES OF AMERICA

CASE NUMBER: 86-3182

___ **Jury Verdict.** This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

X **Decision by Court.** This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED Pursuant to Order entered by The Honorable Richard Mills, Judgment is entered for the Defendant and against the Plaintiff. Cause DISMISSED. Case CLOSED.

August 12, 1988 /s/ John M. Waters

Date *Clerk*

/s/ Gloria Utsingir

(By) Deputy Clerk

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

October 25, 1989.

Before

Hon. JOHN L. COFFEY, Circuit Judge

Hon. JOEL M. FLAUM, Circuit Judge

Hon. KENNETH F. RIPPLE, Circuit Judge

JEROME MIRZA & ASSOCIATES, LTD.,

Plaintiff-Appellant,

No. 88-2774 vs.

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appeal from the United States District Court for the Central District of Illinois, Springfield Division.

No. 86 C 3182

Richard Mills, Judge.

O R D E R

On consideration of the petition for rehearing and suggestion for rehearing *en banc* filed in the above-entitled cause on August 24, 1989, no judge in active service has requested a vote thereon, and all of the judges on the original panel have voted to deny a rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.

STATUTES AND REGULATIONS

EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 ("ERISA").

29 U.S.C. §§ 1001 et seq.
Section 3, 29 U.S.C. §1002

For purposes of this subchapter:

(21)(A) Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 405(c)(1)(B).

Section 302, 29 U.S.C. §1082

(c)(3) For purposes of this part, all costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable expectations) and which, in combination, offer the actuary's best estimate of anticipated experience under the plan.

Section 404, 29 U.S.C. §1104

(a)(1) Subject to sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and –

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administrating the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims:

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title or Title IV.

Section 404, 26 U.S.C. §404

DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN

(a) General Rule – If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or

accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under this chapter; but if they would otherwise be deductible, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

(1) PENSION TRUSTS. –

(A) IN GENERAL. – In the taxable year when paid, if the contributions are paid into a pension trust, and if such taxable year ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), in an amount determined as follows:

(i) the amount necessary to satisfy the minimum funding standard provided by section 412(a) for plan years ending within or with such taxable year (or for any prior plan year), if such amount is greater than the amount determined under clause (ii) or (iii) (whichever is applicable with respect to the plan),

(ii) the amount necessary to provide with respect to all of the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee, as determined under regulations prescribed by the Secretary, but if such remaining

unfunded cost with respect to any 3 individuals is more than 50 percent of such remaining unfunded cost, the amount of such unfunded cost attributable to such individuals shall be distributed over a period of at least 5 taxable years.

(iii) an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Secretary, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount necessary to amortize such credits in equal annual payments (until fully amortized) over 10 years, as determined under regulations prescribed by the Secretary.

In determining the amount deductible in such year under the foregoing limitations the funding method and the actuarial assumptions used shall be those used for such year under section 412, and the maximum amount deductible for such year shall be an amount equal to the full funding limitation for such year determined under section 412.

Code 412(c)(3), 26 U.S.C. Section 412(c)(3)
as in effect in 1980

ACTUARIAL ASSUMPTIONS MUST BE REASONABLE – For purposes of this section, all costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable

expectations) and which, in combination, offer the actuary's best estimate of anticipated experience under the plan.

The above amendment applies to years beginning after December 31, 1987.